DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0023; 01-0024
State Gross Retail Tax & Gross Income Tax
For the Tax Years 1995 to 1998

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ISSUES

I. Applicability of the Gross Income Tax Low Rate.

Authority: IC 6-2.1-2-1; IC 6-2.1-2-1(c)(1)(D); IC 6-2.1-2-1(c)(1)(D)(ii); IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(b); IC 6-2.1-2-3; IC 6-2.1-2-3(b); IC 6-2.1-2-4; IC 6-2.1-2-5; IC 6-2.1-2-5(9); Jefferson Smurfit Corp. v. Indiana Dept. of State Revenue, 681 N.E.2d 806 (Ind. Tax Ct. 1997).

Taxpayer argues that income derived from the services it provides to retail merchants should be taxed at the gross income tax "low rate."

II. Calculation of Taxpayer's Use Tax Liability.

Authority: IC 6-8.1-5-1(b).

Taxpayer argues that the method employed by audit in calculating the taxpayer's use tax liability was inaccurate and a proposed, alternative method calculating that use tax assessment should have been employed.

III. Abatement of Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1(a); IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the Department should exercise its discretion to abate the ten-percent negligence penalty. Taxpayer asserts that it was not negligent or careless in determining its tax liabilities.

STATEMENT OF FACTS

Taxpayer is in the business of providing a service to certain retail merchants. When customers return goods to those merchants, the returned goods are transferred to taxpayer which sorts, consolidates, and packages the goods for final return to the original manufacturer. The retail merchants receive a credit for the returned merchandise. Not all of the goods which taxpayer receives can be returned to the original manufacturer. Depending on the condition of the goods, some of the goods sold as salvage on a secondary market and some of the goods are scrapped. However, taxpayer estimates that between 50 and 70 percent of the goods it receives are returned to the original manufacturer.

The audit determined that for purposes of calculating the taxpayer's gross income tax liability, taxpayer's income was subject to the "high rate" of 1.2 percent. Taxpayer argues that its income should be subject to the low rate of .3 percent. Taxpayer makes this assertion on the ground that it is in the business of providing industrial servicing.

The audit calculated those of taxpayer's purchases which were subject to gross retail (use) tax assessment. The audit arrived at the use tax assessment by calculating the use tax for one month of each year and then extrapolating the percentage to each of the applicable tax years. Taxpayer agrees with the determination that it owes use tax, but challenges the audit's method of calculating that use tax liability.

DISCUSSION

I. Applicability of the Gross Income Tax Low Rate.

IC 6-2.1-2-2(a)(1) imposes a gross income tax on "entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana . . . ." The gross income tax is imposed at two rates, a "high rate" of 1.2 percent and a "low rate" of .3 percent. IC 6-2.1-2-3 "The rate of tax is determined by the type of transaction from the taxable gross income is received." IC 6-2.1-2-2(b). The receipts from wholesale sales and from selling at retail are taxed at the low rate. IC 6-2.1-2-4. Receipts from service activities and other business activities are taxed at the high rate. IC 6-2.1-2-5.

Taxpayer argues that its income fits within the IC 6-2.1-2-4 definition of "wholesale sales" based upon a reference back to IC 6-2.1-2-1(c)(1)(D). That provision defines "wholesale sales" as including, "[r]eceipts from industrial processing or servicing, including: (i) tire retreading; and (ii) the enameling and plating of tangible personal property which is owned and is to be sold by the person for whom the servicing or processing is done, either as a complete article or incorporated as a material, or as an integral or component part of tangible personal property produced for sale by such person in the business of manufacturing, assembling, constructing, refining, or processing."

Taxpayer's argument may be fairly summarized as follows: Under IC 6-2.1-2-1(c)(1)(D), taxpayer is in the business of "servicing." "Servicing" is defined as "wholesale sales." Receipts from "wholesale sales" are taxed at the low rate under IC 6-2.1-2-4.

Taxpayer supports its assertion by reference to a previous, superseded version of IC 6-2.1-2-1 which defined "wholesale sales" as including "receipts from the business of industrial processing, enameling, plating, or *servicing of any tangible personal property . . . ."* IC § 64-2603, chap. 140, § 1941 Ind. Acts. 82.

In further support of its position, taxpayer cites to Jefferson Smurfit Corp. v. Indiana Dept. of State Revenue, 681 N.E.2d 806 (Ind. Tax Ct. 1997). According to taxpayer, Jefferson Smurfit stands for the proposition that, as used within IC 6-2.1-2-1(c)(1)(D), "servicing" is not limited to the enumerated categories of enameling and plating but is intended to encompass a separate, broader, category encompassing the "servicing" of tangible personal property.

The Department must disagree with the taxpayer's conclusions. Taxpayer's activities are more properly characterized as the general provision of services as set out in IC 6-2.1-2-5(9) which makes the high rate of gross income tax applicable to the "provision of services of any character . . . ." Notwithstanding the elimination of the resale requirement in Jefferson Smurfit, implicit in the statutory definition of "industrial processing or servicing" under IC 6-2.1-2-1(c)(1)(D) is the requirement that taxpayer's customer's must be engaged in the business of "manufacturing, assembling, constructing, refining, or processing." IC 6-2.1-2-1(c)(1)(D)(ii). Taxpayer's customers – retail merchants to whom taxpayer provides its sorting, packaging, and return services – do not engage in any of these activities.

What taxpayer's customers are purchasing is simply a "service" unrelated to industrial processing of any kind. Taxpayer's customers could very well sort, package, and return goods themselves. However, taxpayer's customers are purchasing the convenience, economies of scale, and the expertise which the taxpayer is qualified to provide. By consolidating the returned merchandise from a large number of retail outlets (taxpayer's customers) at taxpayer's two Indiana locations, taxpayer provides an efficient and expeditious means of processing the merchandise and relieving the individual retail merchant of that responsibility. Taxpayer does not purchase merchandise. Taxpayer does not sell the merchandise. Taxpayer does not provide industrial services of any kind. Accordingly, taxpayer's activities are properly characterized as the straightforward provision of "services" as defined under IC 6-2.1-2-5(9) the receipts from which are subject to the high gross income tax rate under IC 6-2.1-2-3(b).

FINDING

Taxpayer's protest is respectfully denied.

II. Calculation of Taxpayer's Use Tax Liability.

Taxpayer agrees that certain of its purchases were subject to use tax. Taxpayer disagrees with the means by which the audit determined that use tax liability.

The audit calculated taxpayer's use tax liability for two years. Audit did not consider every purchase made during those two years. Rather, the audit chose one month during each of the two years and determined those purchases which were subject to use tax. For the year 1997, audit chose April as the base month and determined that approximately 60 percent of the purchases made by taxpayer's division one were subject to use tax. Audit extrapolated that 60 percent rate to division one's purchases for the remaining eleven months. Similarly, for taxpayer's division two, audit determined that approximately 14 percent of division two's 1997 purchases were subject to use tax and extrapolated that percentage to the remaining eleven months. For 1998, audit chose November as the base month, determined that approximately 78 percent of division one's purchases were subject to use tax and approximately 17 percent of division two's purchases were subject to use tax. Audit used those two percentage figures as a means of calculating taxpayer's use tax liability for 1998.

Taxpayer argues that the particular methodology by which audit determined its use tax liability is flawed resulting in an excessive use tax assessment Taxpayer argues that the use tax liability for its two divisions should not have been determined separately but that audit should have calculated a single combined percentage for both divisions for both years. Taxpayer provides its own calculations purporting to demonstrate that such a methodology would have produced a unitary percentage of approximately 55 percent and that the application of this percentage would have resulted in a substantial decrease in taxpayer's use tax liability. Taxpayer argues that the use of a single combined percentage would have "smoothed" out any discrepancies or distortions caused by the choice of a single month which, in itself, may not have fairly represented taxpayer's purchases over the entire one-year period. Alternatively, taxpayer suggests that more than one month for each year should have been sampled to determine a more equitable and accurate use tax assessment.

IC 6-8.1-5-1(b) provides in relevant part that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Without arriving at any determination concerning the relative accuracy of either audit's original use tax assessment or the taxpayer's proposed alternative methodology, taxpayer has set out a reasonable argument calling into question audit's calculation of its use tax liability. Accordingly, the audit division is requested to perform a supplemental audit reviewing taxpayer's use tax assessment.

FINDING

Subject to the determinations of a supplemental audit, taxpayer's protest is sustained.

III. Abatement of Ten-Percent Negligence Penalty.

Taxpayer has requested that the ten-percent negligence penalty, imposed under the authority of IC 6-8.1-10-2.1(a), be abated for all the taxpayer's tax liabilities assessed during the years encompassed within the audit report. Taxpayer maintains that any mistakes it made were made in good faith and in the exercise of reasonable care.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations. Id.

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax was due to reasonable cause. 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." Id. In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Taxpayer has offered no substantive explanation for its failure to self-assess use taxes. Taxpayer has provided no statutory or factual basis upon which the Department can justifiably be expected to find a reasonable cause for taxpayer's failure to pay the assessed use tax deficiencies. The taxpayer various assertions and explanations – even taken together – do not rise to the level of "reasonable cause" sufficient to permit the Department to waive the negligence penalty assessed against the accumulated use taxes.

In contrast, taxpayer has provided a specific, statutorily based explanation for its belief that it was subject to the state's gross income tax under the "low rate." However erroneous that belief may have been, taxpayer's explanation is sufficient to rise to the level of "reasonable cause" necessary to abate the ten-percent negligence penalty assessed against the taxpayer's gross income tax liability.

FINDING

Taxpayer's protest is sustained in part and respectfully denied in part.

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